"Bang for your Buck?"

May 2015

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In "Reminiscences of a Stock Operator", written in 1923, Jesse Livermore foreshadows the debate about passive vs. active money management when he states: "It never was my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight! It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time, and began buying or selling stocks when prices were at the very level which should show the greatest profit. And their experience invariably matched mine – that is, they made no real money out of it. Men who can both be right and sit tight are uncommon."[1]

So, what does the big debate about active vs. passive money management mean? Active money management is where a manager actively tries to *outperform* his or her benchmark, for example the S&P 500 if their portfolio consists of large-cap US stocks. Active managers seek to exploit inefficiencies in the markets via trading, fundamental, informational, or technical expertise to provide outperformance, commonly referred to as alpha. Thus, active management is about achieving alpha, the more the better.

Searching for and achieving alpha sounds like a great idea. The reasons for the viability of an active management approach may appear to be obvious and numerous. Active managers claim that markets aren't really efficient. Thus, stock or security selection by brilliant, professional, highly trained and informed teams of analysts and portfolio managers can help find cheap stocks with promising futures, while shunning the overvalued issues which face imminent collapse. Through bull and bear markets, active managers will have the insight and capacity to sell early or to rotate to more defensive sectors, thus avoiding or mitigating the losses that every other market participant will experience. Active managers can avoid stocks with discernible risk such as political or regulatory reform. In the case of hedge funds, the siren call is that of outperforming in up and down markets. By utilizing highly sophisticated risk management techniques while magnifying the returns via leverage, hedge fund managers promise superior absolute returns in all markets, often with reduced risk. Highly skilled active managers at mutual funds, hedge funds, pension funds, and private equity funds constantly evaluate market conditions, valuations, economic data, interest rates and currency outlooks. Clearly, they have the opportunity and capability to anticipate and recognize change so they can position your portfolio for maximum profit.

Passive investing, as you will see below, doesn't do any of that. Passive investing largely refers to *matching* a benchmark. Index funds seek to replicate or mimic the performance of a benchmark such that you earn the index return, minus expenses. In this case, not only do you give up hope of outperforming, but in fact will almost certainly trail the benchmark due to management fees, trading costs, and tracking

[1] Reminiscences of a Stock Operator" by Edwin Lefevre, 1923

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error. Granted, these expenses on the whole are markedly and dramatically lower than the fee levels associated with active fund management.

Why do we favor passive management? Eugene Fama, Nobel Prize winner and one of the most distinguished academics in the financial industry, answered the question succinctly when he recently stated: “An investor doesn’t have a prayer of picking a manager that can deliver true alpha.”[2] In this same interview in 2012, he pointed out that “After costs, only the top 3% of managers produce a return that indicates they have sufficient skill to just cover their costs, which means that going forward, and despite extraordinary past returns, even the top performers are expected to be only about as good as a low-cost passive index fund. The other 97% can be expected to do worse.”[3]

Fama is telling you that active management does not consistently create alpha. There is copious empirical data, some highlighted below, showing that the majority of managers underperform their benchmarks. While Fama’s statement alone should give any individual cause for concern when contemplating the true allure of active management, there are in fact many more arguments that support the passive approach. First, when trying to discern whether a particular manager is good, bad, or just plain lucky, an investors should understand the limitations that exist on doing a correct due diligence analysis of the active manager. For example, how much specific risk in excess of benchmark risk levels has the manager taken in order to achieve superior returns? What is the volatility of the funds you have chosen? Are they more than the market index? Is the portfolio concentrated and not widely diversified, such that any error might cause above-average losses? Is that risk level worth it relative to the extra 1% you may have earned? Over time has the portfolio drifted from their original investment style such that 40% of the “large-cap” portfolio is now invested in mid-cap stocks? Did this style drift contribute to any of the outperformance versus the benchmark? If you compare apples to oranges, of course your outcomes will look different.

There are many factors that play into trying to identify a manager that will outperform. Most individuals are ill-equipped to find this elusive 3% of managers. In addition, even if one did identify one of the top 3% of managers, studies show that the persistency of returns is highly variable. Thus, it is unlikely that the top managers remain at the top during longer timeframes. So it’s easy to find the 3% from past returns, but almost impossible to correctly identify the future 3%, which is what an investor really cares about.

[2] Financial Analysts Journal, Volume 68, Number 6, November/December 2012, “An Experienced View On Markets and Investing” by Eugene F. Fama and Robert Litterman

[3] Financial Analysts Journal, Volume 68, Number 6, November/December 2012, “An Experienced View On Markets and Investing” by Eugene F. Fama and Robert Litterman

Another factor which makes the task even more difficult is the concept of survivorship bias. Essentially, this means that the existing empirical data, which shows that most active managers underperform their benchmarks, is actually worse than it seems. The recent SPIVA US scorecard found that: “Based on data as of Dec. 31, 2014, 86.44% of large-cap fund managers underperformed the benchmark over a one-year period. This figure is equally unfavorable when viewed over longer-term investment horizons. Over 5- and 10-year periods, respectively, 88.65% and 82.07% of large-cap managers failed to deliver incremental returns over the benchmark.” [4] The study also debunked the myth that active management works better in inefficient markets. Thus, one might expect active management outperformance in small cap, international, or emerging markets: “This argument is disputed by the findings of this SPIVA Scorecard. The majority of small-cap active managers have been consistently underperforming the benchmark over the full 10- year period as well as each rolling 5-year period, with data starting in 2002.”[5]

Impact of survivorship bias on performance results

Schlanger and Philips (2013) discussed the importance of accounting for dead funds when evaluating the performance of various fund categories. The study found that: Surviving funds generally outperformed funds that were liquidated or merged; a significant majority of liquidated funds underperformed before closure; a significant majority of funds that were eventually merged underperformed before the merger; and a fund merger generally led to better relative performance compared with periods before the event, but the merged funds' performance still lagged their unmanaged benchmarks.

To test the assumption that closed funds underperformed over the time period evaluated in this paper, we analyzed the performance of all the funds identified by Morningstar as either being liquidated or merged into another fund. We measured the closed funds' excess returns versus a style-box benchmark for the 6, 12, and 18 months previous to the funds' date of closure. Figure 3 presents the results. Clearly, a possible factor leading to the closure of these funds was relative underperformance.[4]

Figure 3. Performance prior to fund closure

Notes: Data reflect periods ended December 31, 2014. The figure reflects the median funds' excess return versus a style benchmark as noted in the Appendix, on page 18. We show here the returns for any fund that was removed from the Morningstar database for any reason.
Sources: Vanguard calculations, using data from Morningstar, Inc.

As managers find themselves underperforming, they lose assets to better performers and ultimately they close their funds or merge them into other funds. Thus, if all these losing funds were still in existence when measuring both the percentage of managers that underperform, as well as the degree to which they underperform, the data would probably be worse than is reported. The box above is taken from a Vanguard research piece on this topic. It shows the underperformance of funds up to 18 months prior to closing. The research also shows that, “in the case of U.S. large-cap value equity funds, at the ten-year horizon, the adjustment for survivorship bias increases the proportion underperforming from 72% to 85%. Indeed, after accounting for this survivorship bias, the degree of underperformance increased across all categories.” [6]

Finally, a compelling reason to utilize passive investing is the cost factor. According to Vanguard, “As of December 31, 2014, investors in actively managed large-cap equity mutual funds were paying an average of .77% annually, and those in actively managed bond funds were paying .45% annually, versus .11%

[4] S&P Dow Jones Indices, McGraw Hill Financial, Aye M. Soe, Senior Director Index Research and Design, December 2014

[5] S&P Dow Jones Indices, McGraw Hill Financial, Aye M. Soe, Senior Director Index Research and Design, December2014

[6] The Case for Index Fund Investing, Vanguard research, March 2015

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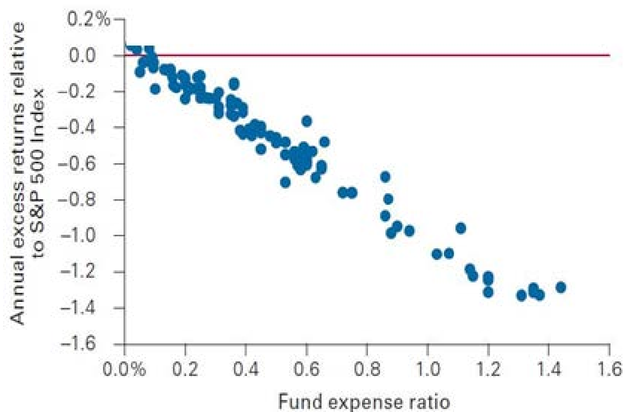

Notes: Dataset represents index funds (all share classes) with an objective of replicating the S&P 500 Index. Data cover ten years ended December 31, 2014.
Sources: Vanguard, using data from Morningstar, Inc.

and .12% for the respective index funds and .14% and .15%, respectively, for ETF's."[7] Observe the adjacent chart which clearly shows that performance declines as expenses increase.

Accordingly, if you have two accounts - one passively managed and the other actively managed - which each earn an 8% gross return but due to the cost differential, one may net a 7.5 % return while the more expensive fund may only earn a net 7%. The difference between a 7% and a 7.5% return on a million dollars compounded over 30 years is an extra $1 million dollars for the less expensive investment! So, you can see that there are plenty of reasons to use the lower cost passive approach.

Charles Ellis, another famed writer in the financial world, summed up the conclusions we have drawn when he recently wrote: "Performance investing has enjoyed a remarkably long life cycle, but the costs of active investment are so high and the incremental returns so low that, for clients, the money game is no longer a game worth playing."[8]

Regards,

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Chief Operating Officer

[7] The Case for Index Fund Investing, Vanguard research, March 2015

[8] Financial Analysts Journal, Volume 70, Number 4, CFA Institute 2014, "The Rise and Fall of Performance Investing", Charles D. Ellis, CFA=

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